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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-26

ESTATE OF JOSEPH MIELE, Deceased, NORMAN E. ALBERS, NICHOLAS JOYA and HORACE D. MARUCCI, Executors, ANTHONY P. MIELE and MARIA E. MIELE, V. JAMES SPINIELLO and GLORIA SPINIELLO, LUKE C. SPINIELLO and GRACE SPINIELLO, and LAFERA CONTRACTING COMPANY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of *Certiorari* To The United States Court Of Appeals For The Third Circuit

PETITION FOR REHEARING

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of *Certiorari* To The United States Court Of Appeals For The Third Circuit

PETITION FOR REHEARING

Petitioners pray that a rehearing of a denial of *certiorari* (No. 73-26) be granted in the above entitled cause and that the Supreme Court review the respective judgments of the United States Court of Appeals for the Third Circuit, rendered below (Nos. 72-1031, 72-1032, 72-1254, 72-1255 and 72-1368), for the reasons stated below.

REASONS FOR GRANTING THE REHEARING

1. *United States* v. *Davis*, 397 U. S. 301 (1970), as it has been applied to the circumstances of this case, represents an unconstitutional extension of congressional taxing power and a denial of the equal protection of the laws.

(a) The effect of the decisions in this case of the Tax Court and of the Court of Appeals for the Third Circuit is to unconstitutionally tax as income a return of capital. It is respectfully submitted that such an application of this Court's decision in *United States* v. *Davis*, 397 U. S. 301 (1970), was not contemplated by this Court therein and that this Court should grant *certiorari* to determine whether *Davis* should be extended to this case.

In *Davis*, this Court was of the view that the question was whether the redemption qualified "for capital gains rather than ordinary income treatment". 397 U. S. at 305. The basic question presented herein is *not* whether the amount paid by A & S Transportation Company ("Corporation") should be taxed as capital gain or ordinary income, but whether, in fact, the petitioners had *any* income to be taxed. As Mr. Justice Powell noted in his dissent herein to the denial of the petition for a writ of *certiorari*, on the sale of the stock back to the Corporation, *"Petitioners received precisely the amount each had previously invested"* and the redemption "provided petitioners nothing more than a return of the capital they were compelled by the [United States Maritime] Commission to pay into [the Corporation]". (Slip Opinion at Page 2). Congress has been granted by our Constitution the power to tax income, but not amounts received as a return of capital. See *Edwards* v. *Cuba R.R. Co.*, 268 U. S. 628 (1925); *Eisner* v. *Macomber*, 252 U. S. 189

(1920); *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179 (1918).

Section 302(b)(1) of the *Internal Revenue Code of 1954*, 26 U.S.C. §302(b)(1), was enacted to prevent taxpayers from avoiding ordinary income or dividend tax treatment by receiving corporate distributions through a redemption of stock where the distributions were, in substance, essentially equivalent to a taxable dividend. *U. S.* v. *Davis*, *supra*, at 308; H.R. Rep. No. 1, 69th Cong., 1st Sess., 5. To determine whether a transaction constitutes, in substance, a distribution of a dividend requires an inquiry into the facts and circumstances of each case. It may be that in the vast majority of cases involving essentially *pro rata* redemptions, the redemptions should be treated as essentially equivalent to a dividend; however, if *Davis* is interpreted as was done by the lower courts here, as foreclosing this factual inquiry and mandating a *per se* rule that all essentially *pro rata* redemptions result in the distribution of income, the effect is to extend, beyond the outer limits fixed by the Constitution, Congress' taxing powers by creating and taxing income where none exists.

The constitutional objection to taxing "phantom income" is not answered by stating that it is proper for Congress to treat corporate distributions as taxable dividends or income when made out of a corporation's earnings and profits irrespective of the substance or form of the transaction. The question presented herein is not whether the *Corporation* had any income, but whether the *stockholders* had income when they sold back to the Corporation preferred stock at the same price that they had paid for it. Nor is it a sufficient answer to say that the question involved is merely an accounting question as to what is the proper time for a stockholder to recognize gain or loss. The constitutional objection to taxing hypothetically-

created income is not cured by giving to the taxpayer a deduction in another year (when he may have no income which would offset it). Furthermore, the supposed mechanism for creating such a deduction in the future, *i.e.*, the potential recognition of a loss or reduced gain on an ultimate sale of stock in the corporation by reason of the taxpayer's adjusted cost basis, is at best a most imperfect form of redress and injects needless complexity into the tax law. In many cases, a taxpayer taxed on a return of capital will never recognize for tax purposes a corresponding deduction, although he has realized a real economic loss. He has been taxed on "phantom income".

(b) The lower courts' interpretation of *Davis,* as applied herein, not only results in an unconstitutional extension of Congress' power to tax, but also results in the denial to petitioners of the equal protection of the laws. If petitioners are taxed on their gross receipts from the redemption, without deduction for their original capital investments, at the same rate as other citizens are taxed on their net income, they are denied the equal protection of the laws.

2. The lower courts' extension of *Davis* to the instant case results in a clear violation of express and unequivocal legislative intent.

Extension of *Davis* to the case at bar represents a clear violation of Congressional intent. Section 302 of the *Internal Revenue Code of 1954* was enacted into law in the form prescribed by the Senate Finance Committee. The House version of the bill contained what are now the provisions of Section 302 (b) (2) and (b) (3), but contained no clause equivalent to Section 302 (b) (1). The Finance Committee explained its insertion of this latter clause as follows (S. Rep. No. 1622, 83d Cong., 2d Sess.):

> "While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, *these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place.* Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend." [Emphasis supplied.]

The *Davis* case involved a voluntary redemption by a taxpayer who, under the rules of attribution, was a sole stockholder. In the instant case, we are dealing with minority stockholders and with preferred stock which under the terms of the instrument and the Corporation's certificate of incorporation, was required to be redeemed within a certain span of time. Pursuant to this requirement, the Corporation did redeem the stock and returned to the petitioners their original capital investment.

The lower courts interpreted *Davis* to mandate a "*per se* rule" prescribing dividend treatment even where redemptions of preferred stock are required of minority shareholders. Such an interpretation, without an inquiry into the substance of the transaction and the facts and circumstances, would apparently require dividend treatment even in a case where there are *pro rata* "redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place", directly counter to the express reason for the Senate Finance Committee's insertion of Section 302 (b) (1).

While *"per se* rules" have advantages in their ease of administration, they can act harshly. The surface appeal of *"per se* rules" oftimes leads courts to apply them too often and too broadly, losing awareness of situations to which their application is inappropriate.

This Court this should grant a rehearing here so that it can examine the situations in which *Davis* should control.

3. In denying a writ of *certiorari* in the instant case, this Court apparently misapplied the doctrine of *stare decisis*.

The Chief Justice and Mr. Justice Brennan dissented in *Davis* and yet did not vote to grant *certiorari* in the instant case. Mr. Justice Powell, in his dissenting opinion herein, inferentially seemed to explain the action of these two members of the Court, and possibly of other members, by his reference to the importance of *stare decisis,* especially with respect to the Tax Code (Slip Opinion at Page 2, n.2). It is respectfully submitted that there should be no reliance on the doctrine of *stare decisis* in this case.

The importance of the doctrine of *stare decisis* in tax cases is to enable *taxpayers* to plan their financial transactions with reasonable certainty as to the tax consequences—that is, to provide security for the taxpayer who relies upon previous decisions. The *Commissioner of Internal Revenue* has little interest that need be protected by a doctrine of *stare decisis,* for he merely administers tax laws as enunciated by Congress and the courts and is not himself a party to any questioned transaction. It is extremely unlikely that any taxpayer would be harmed by an overruling or limiting of the *Davis* de-

cision. Thus, the reason for *stare decisis* is not present. *Cessante ratione legis, cessat et ipsa lex.*

Stare decisis is a policy that should not be applied mechanically. Where a previous holding as applied to a subsequent case leads to a result that is inherently inequitable,[1] in contravention of express legislative intent,[2] this Court, in pursuance of its ultimate obligation of achieving substantial justice, should reevaluate its questionable prior decision to see whether that decision must apply to the case at hand. When there are rational distinctions, the Court should invoke them and avoid the improper result. If rational distinctions cannot be made, the prior decision should fall.

When the effect of a denial of *certiorari* is not a refusal to overrule a prior decision, but is, in fact, a real and significant expansion of that decision, the doctrine of *stare decisis* is not even a relevant consideration.

Furthermore, it is petitioners' contention that if the doctrine of *stare decisis* is to be invoked at all, it should favor a reexamination of *Davis*. The *Davis* case declared that a "business purpose" is irrelevant in deciding the treatment due taxpayers upon their redemption of stock under Section 302 of the *Internal Revenue Code of 1954*. In so holding, the Court acknowledged that only the Second Circuit had arrived at that result, *United States* v. *Davis, supra,* 397 U. S. at 303, n.2, and that the great majority of courts had ruled that a business purpose in a transaction was of critical importance. The preferred stock in the instant case was issued in 1959, and the redemption was made as required by the terms of the in-

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[1] Characterized by Mr. Justice Powell, as "an extraordinary . . . bizarre result" Slip Opinion, at Page 2.

[2] See Point 2 of this Petition.

strument in 1965 and 1966. Thus, the taxpayers and their counsel were relying on the prevailing law at the time in arranging their transactions, and the *Davis* opinion drastically and we submit unwarrantably reversed what petitioners justifiably believed to be the tax consequences to themselves.

CONCLUSION

We respectfully urge this Court to grant a rehearing and, further, issue its writ of *certiorari* to examine the problems raised herein as well as in the petition previously filed. The "*per se* rule" of *Davis* is so out of harmony with economic reality and so unduly harsh as to cry out against a mechanical extension of the rule.

Respectfully submitted,

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November 14, 1973.

Certificate

I hereby certify that this Petition is presented in good faith and not for purposes of delay.

I also certify that this Petition is restricted to grounds previously available to petitioner, but which were not presented to this Court.

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Counsel for Petitioners